Section Two: Additional Views

A. J. Mark McWatters

I concur with the issuance of the June report and offer the additional observations noted below. I appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

1. Cost of AIG Bailout to Taxpayers

Other than the bailouts of Fannie Mae and Freddie Mac, the rescue of AIG has required the allocation of more taxpayer funded resources than any other similar action undertaken by the government since the inception of the current economic crisis. In its January 2010 "Budget and Economic Outlook," the Congressional Budget Office (CBO) estimated that the TARP investment in AIG will cost the taxpayers $9 billion out of $70 billion committed or disbursed.[940] In its March 2010 "Report on the Troubled Asset Relief Program," the CBO *quadrupled* its estimated cost to $36 billion.[941] In the President's Budget for fiscal year 2011 released in February 2010, the OMB estimated that the TARP investment in AIG will cost the taxpayers $49.9 billion.[942] Although the CBO and OMB – experts in making these determinations – appear pessimistic that the taxpayers will recover their investment, AIG nevertheless remains optimistic that the taxpayers will receive repayment in full.[943] It is not entirely clear why such a material

[940] Congressional Budget Office, *Budget and Economic Outlook*, at 14 (Jan. 2010) (online at www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf).

[941] Congressional Budget Office, *Report on the Troubled Asset Relief Program – March 2010*, at 4 (Mar. 2010) (online at www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf).

[942] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011,* at 40 (Feb. 2010) (online at www.whitehouse.gov/omb/budget/fy2011/assets/econ_analyses.pdf.)

[943] The challenge presented with repaying the taxpayers in full is evidenced by the recent collapse of the sale of AIA Group Ltd., AIG's main Asian business, to Prudential PLC, a UK insurer. *See* Peter Stein, *U.S. Taxpayers are Big Losers of AIA Deal's Death*, The Wall Street Journal (June 3, 2010) (online at online.wsj.com/article/SB10001424052748703340904575284280012636818.html?mod=WSJ_newsreel_business), which provides:

> In this scenario, AIG is treating U.S. taxpayers like *private-equity investors* funding its growth in hopes of a nice payoff down the line. That's wrong. *The only way to mitigate the moral hazard of saving AIG is to repay U.S. taxpayers sooner, not later.* This is why a sale yielding $23 billion in cash up front clearly beat the alternatives.
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> An autopsy of this deal might reveal various causes of death. Prudential's overambitious management, fixated on the appeal of a transformative deal, lost sight of the perspective of its more skeptical shareholders. Volatile markets undercut risk appetite right when Prudential and AIG needed investors with strong stomachs.
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> But it was AIG's board, and its U.S. government owners, that pulled the plug. U.S. taxpayers should mourn the fact that with this deal, their best interests expired as well." [Emphasis added.]

disparity exists between CBO scores or on what reasonable basis AIG anticipates that the taxpayers will receive repayment. It is also troublesome that the CBO has quadrupled its estimated cost of the AIG bailout even though market conditions have significantly improved since the last quarter of 2008.

As I have done in prior reports,[944] I think that it is instructive to add some perspective to the magnitude of the loss the taxpayers may suffer as a result of the AIG bailout. By comparison, for fiscal year 2011 the National Institute of Health (NIH) has requested $765 million for breast cancer research, and the latest Nimitz-class aircraft carrier commissioned by the Navy cost approximately $4.5 billion.[945] It is entirely appropriate for the taxpayers who funded the TARP program to ask if the bailout of AIG with a CBO estimated cost of $36 billion merited 47 years of breast cancer research or eight (8) Nimitz-class aircraft carriers. The "guns v. butter v. AIG" comparisons clearly demonstrate that our national resources are indeed limited and that the bailout of AIG will require the government to reduce expenditures, increase tax revenue or both.

2. Collapse of World Financial System if AIG not Rescued

The American taxpayers were told in the last quarter of 2008 that they had no choice but to bail out AIG because absent such action the global financial system would have collapsed due to the systemic risk presented by and the financial interconnectedness of AIG.

- Secretary Geithner has stated that "neither AIG's management nor any of AIG's principal supervisors – including the state insurance commissioners and the OTS – understood the magnitude of risks AIG had taken or the threat that AIG posed to the entire financial system."[946]

See also Serena Ng, *AIG Heads Back to the Drawing Board*, The Wall Street Journal (June 3, 2010) (online at online.wsj.com/article/SB10001424052748704515704575282993879628812.html?mod=WSJ_business_whatsNews); s*ee also* The Associated Press, *Fitch drops positive ratings watch for AIG unit*, Bloomberg Businessweek (June 3, 2010) (online at www.businessweek.com/ap/financialnews/D9G38KH00.htm); see also Paul Thomasach, *AIG shares overpriced after deal collapse-Barron's*," Reuters (June 6, 2010) (online at www.reuters.com/article/idUSN0613653820100606).

[944] *See* Congressional Oversight Panel, *March Oversight Report: The Unique Treatment of GMAC Under the TARP: Additional Views of J. Mark McWatters and Paul S. Atkins*, at 122 (Oct. 9, 2009) (cop.senate.gov/documents/cop-031110-report-atkinsmcwatters.pdf).

[945] *See* U.S. Department of Health and Human Services, *National Institutes of Health, Estimates of Funding for Various Research, Condition and Disease Categories (RCDC)* (Feb. 1, 2010) (online at report.nih.gov/rcdc/categories/); *see also* U.S. Navy, *Information about the Ship (online at up-www01.ffc.navy.mil/cvn77/static/aboutus/aboutship.html)* (accessed Mar.10, 2010).

[946] FRBNY and Treasury briefing with Panel and Panel staff, Apr. 12, 2010; House Committee on Oversight and Government Reform, Written Testimony of Timothy F. Geithner, Secretary, U.S. Department of the

- Secretary Paulson has stated that the failure of AIG "would have taken down the whole financial system and our economy. It would have been a disaster."[947]

- Chairman Bernanke has stated that the FRBNY "lent AIG money to avert the risk of a global financial meltdown."[948]

Although such assessments no doubt motivated the FRBNY and Treasury to rescue AIG, it is critical to note that the global financial system does not consist of a single monolithic institution but, instead, is comprised of an array of too-big-to-fail financial institutions many of which were, interestingly, also counterparties on AIG credit default swaps (CDS) and securities lending transactions (SL). In other words, the concept of a "global financial system" is really just another term for the biggest-of-the-big financial institutions and, as such, there remains little doubt that the principle purpose in bailing out AIG was *by definition* to save these institutions as well as AIG's insurance business from bankruptcy or liquidation. It is troublesome that the plan implemented by the FRBNY and Treasury to save AIG along with the global financial system was without cost to those too-big-to-fail members of the global financial system who were rescued.

Assuming the bailout of AIG was in the best interest of the taxpayers, a number of fundamental questions nevertheless remain for consideration. A private sector solution was negotiated and successfully implemented with respect to the failure of LTCM in 1998. Why not AIG? Was a wholly taxpayer funded bailout of AIG the only viable option available to the FRBNY and Treasury in the last quarter of 2008? What action could the FRBNY and Treasury have taken to orchestrate a pre-packaged bankruptcy of AIG with, for example, post-petition financing provided by the FRBNY *and* a syndicate of domestic and cross-border private sector financial institutions, insurance companies, hedge funds and private equity firms? Would it have been possible for the FRBNY to have extended AIG a short-term loan of 120-days or so while all parties worked to structure a pre-packaged bankruptcy plan? Would it have been possible to coordinate a pre-packaged bankruptcy with the AIG insurance and other regulators? Would it have been possible for the FRBNY to have guaranteed certain obligations of AIG instead of advancing funds under a credit facility? Did the FRBNY and Treasury attempt to negotiate a public-private arrangement where all of the risk of the AIG bailout was not shouldered by the

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Treasury, *The Federal Bailout of AIG*, at 3, 111th Cong. (Jan. 27, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee_on_Oversight/TESTIMONY-Geithner.pdf).

947 House Committee on Oversight and Government Reform, Written Testimony of Henry M. Paulson, Jr., former secretary, U.S. Department of the Treasury, *The Federal Bailout of AIG*, 111th Cong. (Jan. 27, 2010) (online at oversight.house.gov/index.php?option=com_content&task=view&id=4756&Itemid=2).

948 House Committee on Financial Services, Written Testimony of Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, *Oversight of the Federal Government's Intervention at American International Group* (Mar. 24, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/statement_-_bernanke032409.pdf).

taxpayers? If so, why did those efforts fail? Did the FRBNY and Treasury seek the participation of hedge funds and private equity firms as well as traditional domestic and cross-border financial institutions and insurance companies in a rescue attempt? If not, why not? The FRBNY and Treasury had their greatest leverage to negotiate a discount to par with the AIG counterparties in September 2008. Why did they fail to use that position of strength for the benefit of the taxpayers? Although the Panel has addressed many of these issues, I remain unconvinced that the only reasonable approach available to the FRBNY and Treasury during the fourth quarter of 2008 was for the taxpayers to have assumed the full burden of bailing out AIG.

3. Counterparties Unwilling to Share Pain of AIG Bailout with Taxpayers

It is ironic that although the bailout of AIG may have also rescued many of its counterparties,[949] none of these institutions were willing to share the pain of the bailout with the taxpayers and accept a discount to par upon the termination of their contractual arrangements with AIG. Instead, they left the American taxpayers with the full burden of the bailout. It is likewise intriguing that these too-big-to-fail financial institutions (leading members of the "global financial system") were paid at par – that is, 100 cents on the dollar – at the same time the average American's 401(k) and IRA accounts were in free-fall, unemployment rates were sky-rocketing and home values were plummeting.[950]

It is also critical to recall that during the last quarter of 2008 many of the AIG counterparties were most likely experiencing their own severe liquidity and insolvency challenges and were under attack from short-sellers and purchasers of CDSs on their debt instruments.[951] By receiving payment at par, some of the counterparties were able to convert

[949] The CDSs of certain AIG counterparties were terminated through the Maiden Lane III transaction, yet the CDSs of other AIG counterparties remained outstanding. It is difficult to appreciate why the former group of AIG counterparties received payment at par as their CDSs were closed out. Like the Financial Crisis Inquiry Commission, it has been challenging for the Panel to fully appreciate the economic and legal relationships among the AIG counterparties and AIG. *See* John Mckinnon, *Finance Panel Accuses Goldman of Stalling,* Wall Street Journal (June 7, 2010) (online at online.wsj.com/article/SB10001424052748703303904575292530057313818.html?mod=WSJ_hps_MIDDLETopStories).

[950] *See* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets: Additional Views of J. Mark McWatters and Paul S. Atkins*, at 145 (Jan. 14, 2010) (cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

[951] In order to hedge their AIG-related risk, some of the AIG counterparties may have shorted the stock of AIG or purchased CDSs over AIG. It also appears that some of the AIG counterparties entered into back-to-back CDSs, as the protection seller, with their clients (AIG CP clients), as the protection buyers. In order to hedge their AIG counterparty-related risk, some of the AIG CP clients may have shorted the stock of their AIG counterparty or purchased CDSs over their AIG counterparty. These actions may have caused the stock of a wide variety of financial institutions to drop precipitously in late 2008. As the shares of financial institutions fell in value it is likely that other investors joined the trend of shorting and selling the stock of anything that looked like a financial institution. Although the SEC responded with its temporary ban on selling short the stock of financial institutions, one of the goals in rescuing AIG may have been to address this issue. If so, such action serves as yet another indication that the bailout of AIG was also intended as a bailout of the AIG counterparties.

illiquid and perhaps mismarked CDOs[952] and other securities into cash during the worst liquidity crisis in generations.[953] By avoiding the risk inherent in an AIG bankruptcy and the issues regarding DIP financing,[954] some of the counterparties were also able to accelerate the conversion of their AIG contracts into cash, and in late 2008, cash was king. Although some of the counterparties may argue that they held contractual rights to receive payment at par and were the beneficiaries of favorable provisions of the U.S. bankruptcy code, such rights and benefits would have been of diminished assistance since in late 2008 AIG was out of cash. It also appears problematic if AIG would have been able to obtain sufficient post-petition financing following the implosion of the global financial system that – according to the wisdom of the day – would have followed from the bankruptcy of AIG. Thus, without the taxpayer funded bailout, AIG would have most likely held insufficient cash to honor in full its contractual obligations notwithstanding the special rights and benefits afforded the counterparties.[955]

While the facts and circumstances no doubt differed with respect to the contractual and economic relationships of the various counterparties with AIG, the bailout of AIG – at a minimum – reduced systemic risk throughout the global financial system to the benefit of the counterparties and most certainly allowed some of the counterparties to receive a greater distribution than they would have received following the bankruptcy of AIG. Although some of the AIG counterparties were apparently fully hedged – with posted cash collateral – against the bankruptcy of AIG, the retention of the posted cash collateral by the counterparties following the bankruptcy of AIG and the ensuing collapse of the global financial system would have served as

[952] If an AIG counterparty had held $100 of face value CDOs with a true fair market value of $60 and $40 of cash collateral posted by AIG, the counterparty would not have suffered a loss upon the bankruptcy of AIG because the counterparty could have sold the CDOs for $60 and retained the $40 of posted cash collateral. This analysis assumes – perhaps incorrectly – that the bankruptcy of AIG would not have resulted in the collapse of the CDO market or the AIG counterparty. If, however, the true fair market value of the CDOs was $20 (that is, the CDOs were mismarked at $60), the AIG counterparty would have most likely suffered a loss of $40 upon the bankruptcy of AIG. Since the CDO market was all but frozen in the last quarter of 2008, it is quite possible that the CDOs held by some of the AIG counterparties were mismarked and that AIG had posted insufficient cash collateral.

[953] If you're inclined to challenge this analysis, ask yourself one question: In the last quarter of 2008 what would you have preferred to own – (i) a CDS with a bankrupt AIG that is searching for post-petition financing following the collapse of the global financial system or (ii) U.S. dollars equal to the full face amount of the referenced securities underlying your CDS?

[954] It is also clear that many of the AIG counterparties (or their counterparties or both) would have suffered in an AIG bankruptcy for three reasons. First, following the collapse of the global financial system the counterparties (as members of the global financial system) certainly would have suffered and perhaps failed. Second, unless they were fully hedged with posted cash collateral, the counterparties most likely would not have received payment at par in an AIG bankruptcy. Third, upon the collapse of the global financial system, where would AIG have secured post-petition financing to pay anyone – including the counterparties – anything (AIG was out of cash on September 16, 2008)?

[955] This is particularly true if, as previously noted, the referenced CDO securities were mismarked and AIG had posted insufficient cash collateral, or if the fair market value of the referenced CDO securities continued to decline and AIG was unable to post additional cash collateral.

little more than a Pyrrhic victory for the counterparties. If President Geithner, Secretary Paulson and Chairman Bernanke were correct in their assessments of the threat posed by the bankruptcy of AIG to the global financial system, the rescue of the company also saved the AIG counterparties from substantial economic peril if not out-right failure. In light of this reality, the taxpayers should have received a discount to par[956] upon the termination of AIG's contracts with its counterparties.[957] In addition, since the counterparties under the CDSs that the AIG counterparties employed to hedge their AIG-related risk were in effect bailed out upon the bailout of AIG, it would also not appear unreasonable for the taxpayers to have received a discount to par from such counterparties.[958]

The FRBNY and Treasury contend that their bailout plan for AIG was the only viable approach under the circumstances and they have raised a number of objections to more creative and taxpayer-friendly structures that would have yielded concessions from the AIG counterparties and other claimants. I appreciate the arguments offered, but, for the reasons noted below, I do not find them entirely compelling.

The FRBNY and Treasury have argued that it would have been "unfair" to ask the AIG counterparties to accept a discount to par upon the termination of their CDS and SL contracts when other AIG creditors were scheduled to receive payment at par. In workouts of private sector enterprises, creditors often agree to terms that are less favorable than those expressly provided in their contractual agreements – even without the threat of being crammed-down in a bankruptcy proceeding. As such, it would not seem unusual for a group of multi-billion dollar

[956] The successful and timely negotiation of discounts to par from the counterparties would have most likely required the intervention of the Secretary of the Treasury and the President of the FRBNY with the senior executive officers of the counterparties. Although time was of the essence, a meeting at the offices of the FRBNY or a series of conference calls with the principals could have saved the taxpayers several billion dollars. In those meetings and conference calls, the Secretary or President of the FRBNY would have had to address the potential collapse of the global financial system and the consequences to the AIG counterparties as well as the "shared sacrifice" expected of the counterparties (as noted by Martin J. Bienenstock in the text below).

[957] Counterparties who were fully hedged against AIG-related risk with posted cash collateral may have argued with conviction that they owed no duty to accept a settlement of their AIG contracts at a discount to par. By making this assertion they would have failed to acknowledge that the bailout of AIG may have also rescued their institution from bankruptcy or liquidation. Such approach also runs contrary to the "shared sacrifice" expected of the counterparties (as noted by Martin J. Bienenstock in the text below).

[958] If an AIG counterparty was fully hedged with cash collateral posted by the protection seller to the AIG counterparty, as the protection buyer, under a CDS over AIG, the AIG counterparty may have recovered the full benefit of its bargain upon the bankruptcy of AIG. Upon the bailout of AIG, the AIG counterparty would have possibly returned the posted cash collateral to its protection seller and cancelled its CDS over AIG. In such event, the protection seller would have directly benefitted from the bailout of AIG because, absent the bailout, the protection seller would have forfeited the cash collateral posted to the AIG counterparty upon the bankruptcy of AIG. Conversely, if the AIG counterparty was not fully hedged against the bankruptcy of AIG, the AIG counterparty should have been willing to offer AIG a discount to tear-up its CDS with AIG because, absent the bailout of AIG by the taxpayers, the AIG counterparty would have most likely suffered a loss upon the bankruptcy of AIG.

domestic and foreign[959] AIG counterparties to accept a discount to par where other creditors do not. This is particularly true since the failure of AIG may have resulted in the bankruptcy or liquidation of some of these counterparties. Such a reality, along with the fact that many of the counterparties would have received less than par upon the bankruptcy of AIG – the only realistic alternative to a taxpayer funded bailout in the last quarter of 2008, should have ensured the cooperation of the counterparties. In a perfect world, the concept of shared sacrifice would have included most if not all of the AIG creditors, but it was arguably not possible to administer this remedy to an enterprise with thousands of claimants where time was of the essence. When you aggregate the taxpayer funds employed to finance ML2 and ML3 together with the share of the $85 billion FRBNY loan used to post cash collateral with the CDS counterparties and settle redemptions with the SL counterparties, it appears that the counterparties received a substantial bulk of the taxpayer sourced funds further indicating that the bailout of AIG was also a bailout of the AIG counterparties.

The FRBNY and Treasury have also argued that the rating agencies would have downgraded AIG upon the successful negotiation of any discounts to par (a "distressed exchange") and that any such downgrade would have caused the insurance regulators to seize or take other adverse action with respect to AIG's insurance subsidiaries. The negotiation of counterparty concessions as consideration for the termination of AIG's CDS and SL contracts would not have been undertaken merely to enhance the liquidity or solvency of AIG, but, instead, AIG, the FRBNY and Treasury should have firmly requested the receipt of such concessions out of a sense of equity and fairness to the taxpayers. In my view, the liquidity and solvency of AIG were most likely assured once the FRBNY advanced $85 billion to AIG and it seems unlikely – although not without possibility – that the government would have walked away from such a substantial investment of taxpayer funds and allowed AIG to fail. Indeed, the government kept pouring money into AIG after the initial infusion giving the rating agencies little reason to question the long-term liquidity or solvency of AIG. It appears quite clear that AIG's financial stability would not have turned on whether or not the counterparties granted concessions to par upon the termination of their CDS and SL contracts with AIG.

Further, it is significant to note that the taxpayers are not members of a private equity or venture capital firm in search of high-risk entrepreneurial activity and they should not have been treated as such.[960] The taxpayers owed no duty to rescue AIG – a private sector firm – but they nevertheless elected to allocate their limited resources to the firm out of concern that its failure would have spawned dramatically adverse consequences for the American economy. For these

[959] A substantial portion of the taxpayer sourced bailout funds were paid to non-U.S. financial institutions.

[960] Since a private equity firm most likely would have received concessions from creditors in return for providing workout capital to AIG, it is possible that the FRBNY and Treasury committed the taxpayers to a particularly unattractive bailout structure.

reasons, the rating agencies – after thoughtful discussions with AIG, the FRBNY and Treasury, including the Secretary of the Treasury and the President of the FRBNY – should not have viewed any concessions granted by the AIG counterparties as "distressed exchanges" but, instead, as appropriate and good faith consideration payable to a reluctant investor – the taxpayers – for performing a significant public service. I have little doubt that the rating agencies would have grasped this fundamental distinction. In addition, it is not at all clear that the AIG insurance regulators would have acted in the rather dramatic manner suggested by the FRBNY and Treasury. I, again, have little doubt that the insurance regulators would have acted in a prudent manner on behalf of present and future policy holders so as to secure the safety and soundness of the AIG insurance subsidiaries they regulate.

In addition, the FRBNY and Treasury have argued that the failure or downgrade (resulting from a "distressed exchange") of the AIG holding company would have resulted in a "run" on the AIG insurance companies. A number of questions – largely unanswered – are raised by this assertion. Where would the AIG policy holders have run upon the seizure of the AIG insurance subsidiaries? Was there enough excess capacity in the global insurance system to absorb the failure of the AIG insurance subsidiaries? Since property and casualty and even health and life insurance may take a considerable amount of time to underwrite, how would the AIG policy holders have effectively run to another insurance company and received coverage on a timely basis? What action might the insurance regulators have taken to effectively stop any such run?

In essence, the FRBNY and Treasury have attempted to justify the bailout of AIG – without the receipt of any concessions to par from the AIG counterparties for the benefit of the taxpayers – by shifting the responsibility for such approach to the AIG counterparties (because they demanded payment at par), the rating agencies (because they might have downgraded the AIG parent upon the occurrence of a "distressed exchange"), and the insurance regulators (because they might have seized the insurance subsidiaries upon the downgrade of the AIG parent). It may have been preferable for the FRBNY and Treasury to respond as follows "(i) we held no regulatory authority over AIG and its subsidiaries, (ii) to the best of our knowledge the OTS – the primary regulator – was properly discharging its responsibilities, (iii) although we became aware that AIG was experiencing financial stress in the summer of 2008, we reasonably believed that the private sector would supply whatever new capital that AIG might require, (iv) when we became aware in September 2008 that AIG was experiencing severe financial strain and that the private sector would not provide a timely and robust solution, we responded as best we could under the circumstances, (v) yes, upon reflection, we should have paid closer attention to AIG given the extraordinary problems affecting other similar institutions and we should have more closely monitored the ability of private sector participants to provide AIG with capital (perhaps with our assistance), (vi) yes, upon reflection, we should have pressed the AIG counterparties to accept concessions to par upon the termination of their CDS and SL contracts out of a sense of fairness to the taxpayers who reluctantly funded the bailout, and (vii) yes, upon reflection, we believe that it would have been possible to implement a more taxpayer-friendly approach, such as proposed by Mr. Bienenstock of Dewey & LeBoeuf at the Panel's hearing on the AIG bailout."

4. An Elegant Approach to Protect the Interests of the Taxpayers

As noted, the FRBNY and Treasury have advised the Panel that it was all but impossible for the taxpayers to have received discounts to par from the AIG counterparties upon the termination of their CDS and SL contracts with AIG. Not all agree with this assessment. In his testimony before the Panel, Mr. Bienenstock, a leading bankruptcy and restructuring expert,[961] concludes that the FRBNY and Treasury could have structured the bailout of AIG within the time constraints presented during the fourth quarter of 2008 so as to receive concessions to par from the AIG counterparties for the benefit of the taxpayers. In addition, Mr. Bienenstock argues that the choices presented to the FRBNY and Treasury were not merely "binary," that is, additional approaches existed outside of a bailout at par or a bankruptcy filing, and that the advisers to the FRBNY and Treasury were arguably conflicted. It is also interesting to note that his suggested plan could have been implemented under existing law. Mr. Bienenstock's written testimony contains the following summary of his approach and its impact on AIG creditors:

> …AIG was in a position to advise certain creditor groups such as the CDS counterparties, as follows:
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> 1. State law recovery actions against AIG would be unlikely to yield any benefits due to the prior lien held by FRBNY;
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> 2. AIG would not voluntarily file bankruptcy;
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> 3. Creditors would be unable to file involuntary petitions in good faith because AIG was generally paying its debts as they became due, even if AIG were not to post additional collateral or pay certain other debts of the entities that caused its losses.[962]
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> 4. If creditors nevertheless filed involuntary bankruptcy petitions against AIG, they would render themselves liable for compensatory and punitive damages if

[961] Martin J. Bienenstock is a member of the law firm, Dewey & LeBoeuf LLP, where he is chair of its Business Solutions & Governance Department and a member of its Executive Committee. Mr. Bienenstock also teaches Corporate Reorganization as a lecturer at Harvard Law School and University of Michigan Law School.

[962] *See* 11 U.S.C. § 303(h).

the court found AIG was generally paying its debts as they became due and the creditors had been warned in advance of that fact;[963]

5. FRBNY was saving AIG with taxpayer funds due to the losses sustained by the business divisions transacting business with these creditor groups, and a fundamental principle of workouts is *shared sacrifice*, especially when creditors are being made better off than they would be if AIG were left to file bankruptcy.

The impact of the forgoing on the creditors would include:

1. The knowledge that enforcement action would be unlikely to yield recoveries;

2. The knowledge that an involuntary bankruptcy petition would be a 'bet-the-ranch' venture by the creditors because the risk of suffering compensatory and punitive damages for knowingly bankrupting AIG when it was generally paying its debts as they became due;

3. The knowledge that any creditor enforcement action would be highly publicized and would isolate the creditor in the public as working against the efforts of the United States and its taxpayers to save AIG and the financial system; and

4. The knowledge by some of the creditors that working against the United States would be singularly unwise after the United States either provided them rescue funds or helped them buy a company such as Lehman Brothers for $250 million plus the appraised value of the Manhattan office tower it owned.

The foregoing strategy concentrates pressure on creditors to grant debt concessions, while yielding them very few alternatives to granting concessions, and no alternatives lacking delay, expense, and uncertainty. Unlike the negotiating strategy that SIGTARP described as having had little opportunity for success, this strategy is not based on bluffing bankruptcy. It is based on straight talk and acknowledging there would be no bankruptcy. Additionally, FRBNY retained an outstanding law firm and attorney for its work. But, the law firm is identified as having Wall Street institutions such as JP Morgan as clients, and it would be awkward for it to devise strategies to obtain concessions from those institutions.

Significantly, the foregoing strategy eliminates or at least answers many of the reasons that ultimately caused FRBNY not to obtain concessions.[964] For instance,

[963] *See* 11 U.S.C. § 303(i)(2).

all lenders are justified in requiring shared sacrifice. *Therefore, FRBNY would not have been using its regulatory status to demand concessions. It could do so in its lender status. Most importantly, FRBNY was not required to bluff about bankruptcy. The correct strategy was the opposite – to show there would be no bankruptcy and no real opportunity for the creditor to do better.* The foregoing process is carried out in conference rooms, not in the public.[965]

[Emphasis added.]

It is critical to note that the *amount* of any discount to par the taxpayers may have received from the counterparties under Mr. Bienenstock's approach is not necessarily the key issue. Instead, the fundamental issue concerns the "principle of a discount" for the benefit of the

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[964] Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, at 18-19 (Nov. 17, 2009) (online at sigtarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf).

[965] *See* Congressional Oversight Panel, Written Testimony of Martin J. Bienenstock, partner and chair of business solutions and government department, Dewey & LeBoeuf, *COP Hearing on TARP and Other Assistance to AIG*, at 3-4 (May 26, 2010) (online at cop.senate.gov/documents/testimony-052610-bienenstock.pdf). Mr. Bienenstock also notes in his testimony:

> While the FRBNY might still be concerned about the sanctity of [the] contract, fairness in debtor-creditor relations exists when creditors share the pain, not when taxpayers bail out contracts they did not make. I acknowledge this is often counterintuitive. We all grow up learning to carry out all our promises. In debtor-creditor relations, however, once a debtor cannot carry out one promise to one creditor, it is more fair to break more promises so similarly situated creditors share the pain, rather than having one take all the pain, or worse yet, having innocent taxpayers take all the pain.
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> I understand there was also a concern about ratings downgrades following any concessions. Intuitively, it should be illogical that AIG would be viewed as a lesser credit risk once it procured concessions from creditors which would reduce the amount AIG needed to borrow from FRBNY and would reduce future debt service expense. To be sure, the ratings protocols may not always appear logical to the layperson, but given the singular unique aspects of the AIG rescue, it is hard to figure out why the ratings agencies would believe AIG would be less credit worthy without creditor concessions.
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> The argument exists that creditor concessions could signal that FRBNY may not continue to provide AIG funds to satisfy all debt. The answer to that is that FRBNY has not provided that assurance. Indeed, I received many phone calls in September 2008, asking whether it was safe to buy or hold AIG bonds after FRBNY provided the $85 billion facility. The market clearly understood that FRBNY did not provide any guaranties to creditors for the future. Therefore, it would be illogical for a downgrade to turn on whether AIG already obtained concessions. The risk of a future default is the same or less if prior concessions were granted.
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> Recent experiences with workouts of the monoline insurance companies help corroborate the likelihood of concessions. I have had limited involvement in those negotiations, but my firm has been very involved on behalf of the insurance companies. In those restructurings, institutional lenders, including French institutions, were similarly owed additional collateral to secure credit default swaps and other derivatives. Consensual discounts were and are being granted in very material amounts. Additionally, there is litigation pending today over whether certain credit default swaps qualify for any priorities in payment afforded insured contracts under state law. Accordingly, there are many uncertainties causing counterparties to grant consensual discounts.

taxpayers or, as Mr. Bienenstock states, the principle of "shared sacrifice" among the AIG creditors. The American taxpayers have repeatedly proven themselves profoundly generous to the commercial and investment banking communities and other institutions such as AIG over the past two years. The reluctant acceptance by the taxpayers of the numerous bailouts, however, is founded upon the implicit understanding that Wall Street *share* the financial burden with the taxpayers. The bailout of the AIG counterparties at par without a gesture of support to the taxpayers breached that agreement and further alienated Main Street from Wall Street.

5. Exacerbation of Main Street v. Wall Street Debate

I appreciate that the senior management and counsel of some of the AIG counterparties may cite standards of fiduciary duty as a defense to their unwillingness to accept any concessions to par. It is quite possible, however, that these officers owed a higher fiduciary duty which was to save their respective institutions from the very real threat of bankruptcy or liquidation that existed in the final quarter of 2008. After all, who can forget the photograph of the two-dollar bill taped to the door of Bear Stearns's New York offices?[966] That image – like Charles Dickens' ghost of Christmas future – told the story of what *would* come to pass for other financial institutions, such as AIG and its counterparties, absent the intercession of the American taxpayers. In the dark days of late 2008 when AIG faltered, the American taxpayers – not the FRBNY or Treasury – stood as the last safe-haven for many of these financial institutions, and much of today's Main Street v. Wall Street debate would have never arisen if Wall Street had properly acknowledged the American taxpayers as its sole benefactor. To many on Main Street, the bailout of AIG serves as the prototypical example of the moral hazard risks presented by government-sponsored bailout funds and implicit guarantees where favored claimants are paid in full out of seemingly limitless taxpayer funds, even though many of the recipients would have surely received less in a bankruptcy proceeding. As such, after the bailouts, it has become exceedingly difficult for many Americans to accept that what's good for Wall Street is necessarily good for Main Street.

6. Other Issues

Other significant issues have arisen with respect to the bailout of AIG, including, without limitation, the following:

(1) Even though, according to OMB, the taxpayers stand to lose up to $49.9 billion[967] on the allocation of TARP funds to AIG, the *pre-bailout* common shareholders of AIG were

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[966] *See* Kristina Cooke, *Bear Stearns and the $2 Bill*, Reuters (Mar. 17, 2008) (online at blogs.reuters.com/reuters-dealzone/2008/03/17/bear-stearns-and-the-2-bill/).

[967] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011*, *Analytical Perspective*, Table 4-7 at 40 (online at www.whitehouse.gov/omb/budget/fy2011/assets/econ_analyses.pdf) (accessed June 9, 2010).

permitted to retain their interests in the company. These shareholders should have been wiped out, yet, since AIG avoided a bankruptcy filing and its common stock is publicly traded, they are free to sell their shares and retain the proceeds. The FRBNY and Treasury have placed the taxpayers in an awkward position of suffering substantial losses even though the pre-bailout shareholders were permitted to retain their equity positions in AIG.

(2) The FRBNY and Treasury have made much of the fact that the assets acquired by ML2 (RMBS) and ML3 (collateralized debt obligations) have appreciated in value to the benefit of the taxpayers. At the time the ML2 and ML3 deals were struck, however, most of these assets were arguably below junk status with no reasonable expectation that the RMBS and CDO markets would turn in the near future. Far from being an insightful investment opportunity for the taxpayers, the FRBNY simply took what collateral was available in the last quarter of 2008 and benefitted from a fortuitous and unanticipated rebound in the markets.[968]

More significantly, since the FRBNY and Treasury were under no obligation to bail out the AIG CDS and SL counterparties at par, any economic gain generated by ML2 and ML3 should only be viewed as an offset to the economic losses suffered by AIG and the taxpayers upon the termination of the AIG CDS and SL contracts at par. Since the government owns approximately 80 percent of the equity in AIG, the interests of the government and AIG should be treated as a single economic unit in making these determinations. For example, when AIG terminated certain of its CDS contracts in November 2008 (i) it forfeited approximately $35 billion of previously posted cash collateral to the CDS counterparties and (ii) ML3 purchased the referenced CDO securities from the CDS counterparties for approximately $27 billion. Any subsequent appreciation in the fair market value of the CDO securities above $27 billion should be viewed as a partial recovery of the $35 billion of forfeited cash collateral, not as "profit" generated from the ML3 transaction.

If, instead, AIG had not terminated the CDS contracts in November 2008, the $35 billion of posted cash collateral would have remained in place and upon any subsequent appreciation in the fair market value of the CDO securities above $27 billion, the CDS counterparties would have been obligated to return to AIG cash collateral in an amount equal to the appreciation. Since the taxpayers own approximately 80 percent of AIG, they would have benefitted from the return of the previously posted cash collateral to AIG by the CDS counterparties. In other words, the taxpayers will benefit from any post-November 2008 appreciation in the fair market value of the referenced CDO securities through their ownership interest in ML3, and the taxpayers also would have benefitted from any such appreciation through their ownership interest in AIG if AIG had left the CDS contracts outstanding and not undertaken the ML3 transaction. Since the economic consequences to the taxpayers appear substantially similar under both approaches, the

[968] If a rebound had been anticipated, the RMBS and CDO markets would not have been moribund at the time the Maiden Lane II and Maiden Lane III transactions were closed.

FRBNY could have arguably left the AIG CDS contracts in place with, perhaps, an agreement to post additional cash collateral as required under the CDS contracts (which undertaking would not have been required since the referenced CDO securities in the aggregate have appreciated in value since November 2008). It is problematic for the FRBNY and Treasury to assert that the use of the ML3 vehicle achieved a materially superior result for the taxpayers.

(3) I encourage SIGTARP to continue its investigation into whether the FRBNY or Treasury encouraged or instructed AIG not to release material information to the public, including, without limitation, the names of and referenced securities held by certain AIG counterparties and the decision to terminate the contracts of such counterparties at 100 cents on the dollar.

(4) In order to mitigate the moral hazard risks presented by the bailout of AIG, the government should exit its investment in AIG as soon as is reasonably possible and return AIG to the private sector. Although I do not recommend that the government "fire-sale" its investments in AIG, I cannot endorse a long-term "buy and hold" strategy. I am also troubled that the retention of AIG securities in a trust format may prolong the disposition process and appear to make government sponsored bailouts somehow more palatable to the taxpayers.

(5) Since the overwhelming majority of highly trained investment professionals working on Wall Street and elsewhere throughout the global financial services community failed to recognize on a timely basis the underlying causes of the recent financial crisis, I have little confidence that a group of systemic regulators would have performed in a more insightful or beneficial manner. AIG and its subsidiaries were overseen by more than 400 regulators throughout the world who were charged with enforcing countless volumes of regulations. Although AIG's primary regulator – the OTS – as well as certain of its other regulators no doubt failed to discharge their oversight responsibilities, particularly with respect to AIGFP, it does not follow that AIG and its subsidiaries were necessarily under-regulated, or that the prudent enforcement of existing regulations would not have averted AIG's financial crisis. It is quite likely that many of AIG's regulators fully understood that AIG was writing trillions of dollars of CDS contracts and purchasing RMBS with proceeds from its SL transactions, but very few, if any – including, apparently, the Ph.D's employed by AIGFP – truly appreciated the interconnected risk embedded in these investment strategies. The distinction between incompetency in execution and insufficiency in scope is critical.[969] This is not to say, however, that out-of-date regulations should not be appropriately revised, that new, thoughtfully targeted regulations should not be introduced and enforced, or that enhanced, yet rational regulatory models should not be explored and implemented.

[969] *See* Greg Gordon, *To justify AIG's bailout, regulators overlooked its colossal problems*, McClatchy Newspapers (June 8, 2010) (online at www.kansascity.com/2010/06/08/v-print/2002541/to-justify-aigs-bailout-regulators.html).

(6) Additional questions for which the taxpayers have not received satisfactory answers remain, such as the following: Is AIG – as presently structured – too big or too interconnected with the financial system and the overall economy to fail? What action has AIG taken to mitigate the too-big-to-fail problem? What risk management and internal control policies and procedures has AIG implemented so as not to require a future bailout from the taxpayers? What action has AIG taken to prepare for the failure of the holding company and its insurance subsidiaries? What effect does AIG's too big-to-fail status and its implicit guarantee have on its competitors? What is the exit strategy of the FRBNY and Treasury and when will the taxpayers receive repayment of the funds advanced to AIG? In what businesses will AIG be engaged one year and five years from now? Why did the OTS and the other AIG regulators fail to regulate AIG fully and effectively?